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NOTES ON THE GRAMM-RUDMAN-HOLLINGS DEFICIT REDUCTION
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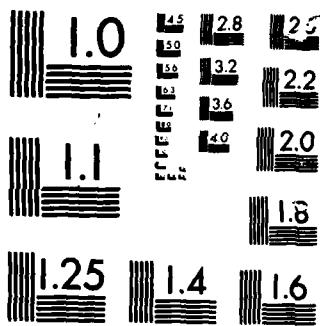
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A RAND NOTE

NOTES ON THE GRAMM-RUDMAN-HOLLINGS DEFICIT
REDUCTION PLAN

Glenn A. Gotz

March 1986

N-2426-FMP/RA

Prepared for

The Offices of the Assistant Secretaries of
Defense for Force Management and Personnel
and for Reserve Affairs

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The Department of Defense (DOD) may be significantly affected by the Gramm-Rudman-Hollings deficit reduction plan (GRH), formally called the Balanced Budget and Emergency Deficit Control Act of 1985, Public Law 99-177. Although the broad outlines of GRH are widely known, the details are not well understood, and there is still disagreement as to how it is to be implemented and whether it is constitutional in whole or in part. This Note describes and comments on aspects of GRH which have not received much attention in the press, but which may have important effects on the DOD budget and on spending incentives within the Department of Defense. *Keywords:*

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PREFACE

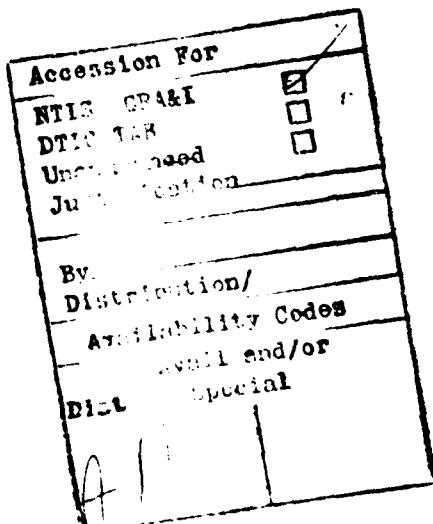
This Note describes and comments on aspects of the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985 which have not received much attention in the press, but which may have important effects on the Department of Defense budget and on spending incentives within DoD. The comments should be of interest to decisionmakers within and outside DoD who must make resource allocation decisions in light of the deficit reduction plan.

In addition to the legislation itself and other publications, the Congressional Budget Office was a major source of information in assembling these notes. The author is particularly indebted to Dr. Neil Singer, Deputy Assistant Director of the Congressional Budget Office, who offered valuable insights into the Gramm-Rudman-Hollings plan. Discussions with Rand colleagues James Dertouzos, Edmund Dews, Gary Massey, and Adele Palmer were also helpful. Useful comments and suggestions were provided as well by Nancy Spruill and Paul Hogan of the Office of the Assistant Secretary of Defense for Force Management and Personnel.

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NOTES ON THE GRAMM-RUDMAN-HOLLINGS DEFICIT REDUCTION PLAN

Introduction

The Department of Defense (DoD) may be significantly affected by the Gramm-Rudman-Hollings deficit reduction plan (GRH), formally called the Balanced Budget and Emergency Deficit Control Act of 1985, Public Law 99-177. Although the broad outlines of GRH are widely known, the details are not well understood. Indeed, at the time of writing there is still disagreement as to how it is to be implemented and whether it is constitutional in whole or in part.¹

The purpose of this Note is to describe and comment on aspects of GRH which have not received much attention in the press, but which may have important effects on the DoD budget and on spending incentives within the Department of Defense.

The Gramm-Rudman-Hollings (GRH) Deficit Reduction Plan

GRH establishes limits on the size of the annual federal budget deficit--outlays minus revenues--and establishes budgetary procedures that will be set in motion if the *projected* deficit for a given budget year exceeds the GRH-established limit for that year. Although these GRH-mandated procedures operate directly through constraints on budget authority rather than on outlays, the goal is outlay reduction--as the following pages will make clear.

Some federal outlays are permanently exempted from GRH cuts. These include social security benefits, Aid to Families with Dependent Children (AFDC), veterans' pensions, and interest on the federal debt. GRH also provides for optional exemptions during FY 1986--as discussed below. Because GRH provides for fixed dollar deficit goals, these exemptions cause other budget elements to absorb larger cuts.

¹The Supreme Court will decide on the constitutionality of the provision requiring the Comptroller General to direct the President to implement the Gramm-Rudman-Hollings procedure described below. If the provision is unconstitutional, the Congress must pass a law directing the President to implement the procedures, making implementation of the budget cuts required by Gramm-Rudman-Hollings problematic.

The GRH budgetary procedures are triggered if a consensus projection of the deficit exceeds the GRH limit by any amount in FY 1986 and FY 1991, whereas in fiscal years 1987 through 1990 it is triggered if the consensus projection exceeds the GRH limit by more than \$10 billion. The consensus projection is the "average" of the projections made by the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO), as validated by the General Accounting Office (GAO). The word "average" is emphasized here because it is not clear how the GAO will adjudicate any differences between the OMB and CBO projections.

The calculation of the deficit for a fiscal year is based on projected outlays from that year's appropriations bill, if one has become law, or on a continuing resolution, if not. If neither an appropriations bill nor a continuing resolution has become law, then projected outlays from the previous year's appropriations bill or continuing resolution is the base for deficit calculations.

How GRH Will Be Implemented

GRH requires that the Department of Defense bear 50 percent of the total federal outlay reduction.² In FY 1986, the deficit will exceed the deficit limit specified by GRH by more than \$20 billion. However, because GRH did not take effect until the beginning of March 1986, the legislation does not require outlay reductions until five months into the fiscal year. Further, the legislation specifies that an outlay reduction of no more than \$20 billion is required for all of FY 1986. Therefore, the government is required to reduce its outlays by \$11.7 billion (an annual reduction rate of \$20 billion over the remaining seven months of the year), which means that the Department of Defense must reduce its outlays by \$5.85 billion. For FY 1987, if there is no tax increase, and no new appropriations bill, the deficit may exceed the GRH limit by \$50 to \$60 billion.

² The DoD share of federal outlays is less than 50 percent. This is true even after subtracting out programs exempted from GRH cuts.

How is the DoD reduction in outlays to be achieved? GRH requires that budget authority be canceled by enough to achieve the desired reduction in outlays. GRH does not allow much flexibility about how the budget cuts are to be implemented. Cuts are to be made at the level of "program, project, or activity (PPA)." Initially it seemed that PPA defined a level of detail at least as specific as the line item, and certainly more specific than the appropriation account. But this point is now in dispute. The Department of Defense is arguing that the PPA level is the equivalent of the appropriation account. The outcome of this dispute will make a substantial difference in the amount of flexibility DoD will have in adapting to the GRH cuts.

The cancellation of budget authority triggered by GRH is termed sequestration. Sequestration of budget authority is permanent, i.e., sequestered budget authority is not automatically restored the following fiscal year. However, sequestering budget authority does not affect the law providing the budget authority. Thus, if no appropriations act or continuing resolution is enacted for a fiscal year, the base for GRH cuts is the previous year's appropriations act or continuing resolution gross of sequestered budget authority.

The DoD outlays covered by GRH include outlays from appropriations voted for the current fiscal year and outlays from unobligated balances of appropriations voted for in previous years. Unless the Department of Defense chooses to limit them, outlays in the current fiscal year arising from obligations in previous fiscal years are unaffected by GRH. If the Department of Defense decides to reduce such outlays and is successful in doing so, it will realize a dollar-for-dollar credit for the reductions. That is, the Department of Defense can increase other outlays by as much as the outlays on previously obligated appropriations are reduced. Reducing these previously obligated outlays, however, may prove to be more easily decided than done.³

³See Gary Massey, et al., *Air Force Outlay Control: Management Implications and Options*, The Rand Corporation, R-3269-AF, November 1985.

As a first approximation, assume that GRH will require all line item amounts to be cut by the same percentage to achieve a specified reduction in outlays. Achieving a given dollar reduction in outlays requires a much greater reduction in budget authority because not all the appropriations voted by Congress for a given fiscal year are actually spent in that fiscal year. In particular, only a small proportion of the DoD procurement appropriation is spent during the year for which the appropriation is voted.⁴ For example, a \$1 reduction in FY 1986 appropriations for procurement might yield a reduction of perhaps \$0.10 to \$0.20 in outlays during FY 1986.⁵ The personnel appropriation, on the other hand, is almost entirely spent in the same fiscal year in which it is authorized. Suppose that for the DoD budget as a whole, of the money authorized in FY 1987 plus unobligated budget authority from previous years, 55 percent is expected to be spent in FY 1987. Achieving a \$30 billion cut in outlays requires sequestering \$54.5 billion of budget authority if all unobligated budget authority is reduced by the same percentage.⁶ (The 55 percent is the average percentage of newly voted appropriations and previously unobligated balances spent in the fiscal year. Because it is a weighted average across line items, this percentage is sometimes called the weighted outlay rate.)

The FY 1987 weighted outlay rate for the Department of Defense is estimated to fall between 50 and 60 percent. If that estimate is accurate, DoD budget authority will have to be reduced from \$1.67 to \$2.00 to achieve each dollar reduction in outlays. A hypothetical example illustrating the application of the weighted outlay percentage to budget authority follows.

⁴For the FY 1984 DoD procurement appropriations, the estimated outlay rates are 13 percent in that fiscal year, and for the next six years, 33, 25, 11, 7, 6, and 5 percent, respectively. See Congressional Budget Office, *Budgeting for Defense Inflation*, January 1986.

⁵The Massey et al. report contains a clear discussion of the relationship between outlays, obligations, and appropriations. It also examines the problems inherent in controlling annual outlays on short notice, and suggests measures that the Air Force should take in the longer term to manage those outlays.

⁶\$54.5 billion = \$30 billion/0.55.

Suppose for simplicity that the DoD budget consists of only two elements: an operating and support (O&S) line item and a procurement line item. Assume that each line item is budgeted at \$150 billion, that 100 percent of the O&S account is spent in the year in which it is authorized, and that 20 percent of the procurement account is spent in the year in which it is authorized. Using those figures, we find that out of \$300 billion authorized during the fiscal year, \$180 billion will be spent during that same year. (Remember that outlays from previous years' obligations are not a part of the GRH calculations.) If we assume that the 100 percent and 20 percent figures are constant over time, then achieving a given dollar reduction in outlays requires a 1.67 times larger reduction in budget authority if both line item amounts are reduced equally.

In the example above, if both O&S and procurement amounts are reduced equally, outlays from the accounts are reduced unequally. Suppose the goal is to reduce current year outlays by \$100. To achieve this, the budget authority for each account must be reduced by \$83. However, current year O&S outlays are reduced by the entire \$83, whereas procurement outlays are reduced by \$17. If procurement was a larger proportion of the DoD budget, O&S outlays would be cut even more. However, outyear procurement outlays are cut by the remaining \$66 if spending authority is not restored. Counting the spending reduction in the outyears, we find that the total outlays from a given year's budget authority are actually reduced by 67 percent more than the outlay reduction targeted for that year.

FY 1986 Special Provisions

The Department of Defense was given more flexibility in implementing the FY 1986 GRH cuts than is allowed in later years. First, during FY 1986, the percentage cut for a line item amount could range from one-half to twice the DoD-wide average percentage cut in budget authority or the item could be specifically exempted from being cut. A smaller cut in one item, however, was offset elsewhere in the budget. Congressional interest items (budget items for which appropriations are at least 110 percent of the President's request) could not be reduced by more than the DoD-wide average percentage cut.

Second, during FY 1986, the Administration could protect the military personnel account as much or as little as it chose. That is, the percentage cut could have ranged from zero to twice the DoD-wide average percentage cut in budget authority. As discussed above, because the total outlay reduction target is the same, other elements were cut by more because the personnel budget was cut by less. Remember that if personnel budget authority is increased by a dollar, the remaining spending authority in the DoD budget must be cut by *more* than one dollar to achieve a one-dollar reduction in current year outlays.

The weighted outlay rate of nonexempt portions of the DoD budget other than personnel is approximately 38 percent. Thus, in FY 1986, because the Department of Defense chose to exempt almost all of its military personnel account, it had to sequester \$2.63 of budget authority in the nonexempted categories to achieve each \$1 reduction in FY 1986 outlays.⁷

The Stable Outlay Rate Assumption

The smooth functioning of the deficit reduction plan depends on stable outlay rates by spending category, but there are no compelling reasons to believe that these rates will remain constant over time. A memorandum to the author suggests the following:

If new contracts counted on by Defense contractors are delayed or eliminated, some of those contractors may begin delivering more rapidly on existing contracts (if they have the labor flexibility to do so), thus increasing the amounts claimable as progress or on-delivery payments and thus alleviating the immediate cash crunch they might otherwise face. In the long run the government will save outlays in proportion to the amount by which they cut obligations, but the only direct leverage the government has over the timing of current outlays is in the speed or tardiness with which it pays its bills.⁸

⁷The personnel account spends 99 percent of its appropriation in the year in which the appropriation was voted. The remaining accounts spend an average of 38 percent of their appropriations in that year.

⁸Gary Massey, unpublished memorandum, January 1986. Contracts are almost always written so that the producer has flexibility in determining his delivery schedule as long as the producer is *not late*.

An important question is whether organizations and individuals within the Department of Defense can and will actually reduce outlays in some fixed proportion to the reduction in budget authority. For example, it is possible that first-year outlays for many accounts will not diverge greatly from past experience in response to reductions in spending authority. As long as an account's first-year outlay rate is less than 100 percent, a reduction in budget authority could be partly countered by reducing outyear outlays rather than current-year outlays. The legislation appears to *assume* that outlay percentages will remain constant over time, but individual incentives working within management systems designed to control obligations, not outlays, could easily invalidate that assumption.

Possible Effects on Procurement and Personnel

A procurement appropriation can take more than one "hit" in the GRH process. Not only can the initial budget authority be reduced, but outlays from the appropriation's unobligated balances may be reduced in subsequent years. For that reason, procurement managers will have increased incentives to obligate budget authority in the year in which the appropriation was voted, even if the outlays from those obligations will not be made for many years. Such actions would leave less budget authority to absorb GRH cuts that occur in the subsequent years, thereby causing other future budget authority to take larger cuts.

GRH will almost surely drive new procurement budget authority down significantly, and the effects will be felt for years. When annual buys (and hence production rates) are reduced, the unit costs of production will often be increased. Thus, achieving specified reductions in outlays will require greater than proportional reductions in the purchases of defense systems.⁹

Cutting personnel end strength may be the only way to sufficiently reduce outlays on personnel in FY 1987 and subsequent fiscal years. However, increases in separation, permanent change of station (PCS)

⁹ Personal communication to the author from Edmund Dews of The Rand Corporation.

costs, severance pay for officers, and outlays for retirement pay will offset part of the reduction achieved in basic pay costs. Increasing personnel budget authority by \$1 while holding total DoD outlays constant requires reducing other DoD budget authority by \$2.63.

Beginning in FY 1987, GRH will cut current-year personnel outlays disproportionately to total DoD outlays. Suppose DoD outlays must be reduced by \$30 billion and the total DoD weighted outlay rate is 55 percent. To achieve this outlay reduction, \$54.5 billion of DoD budget authority must be sequestered (\$30 billion/0.55). Approximately \$13.6 billion of the budget authority reduction will be borne by the personnel account--representing a reduction in FY 1987 personnel outlays of \$13.5 billion. With those figures, the personnel outlay reductions will account for approximately 45 percent (\$13.5 billion/\$30 billion) of the 1987 DoD outlay reductions.

A Cross-Subsidy from Defense to Non-Defense Accounts?

Because GRH will be effective for five years, a cross-subsidy may accrue from the Department of Defense to non-defense agencies. The Department of Defense's outyear procurement account outlays will be reduced because of reductions in current-year budget authority. The resulting smaller federal budget deficits will reduce the size of future budget cuts required of *all* federal agencies, not just the Department of Defense: for every \$1 reduction in outyear outlays, the Department of Defense's GRH cuts will be reduced by \$0.50 in those years. Because of this, the rest of the federal government could be subsidized by \$7 billion because of the 1987 DoD GRH cuts and even more because of the 1988, 1989, and 1990 cuts. Of course, such a scenario would occur only if Congress fails to restore the outyear DoD spending authority that is automatically lost with the GRH cuts. It would be open to Congress to make full or partial restoration, but without full restoration there is the likelihood of a substantial cross-subsidy from defense to non-defense activities.

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